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Before the National Commission on Fiscal Responsibility and Reform

Wednesday, June 30, 2010
Dirksen Senate Office Building
Room 608

Washington, DC

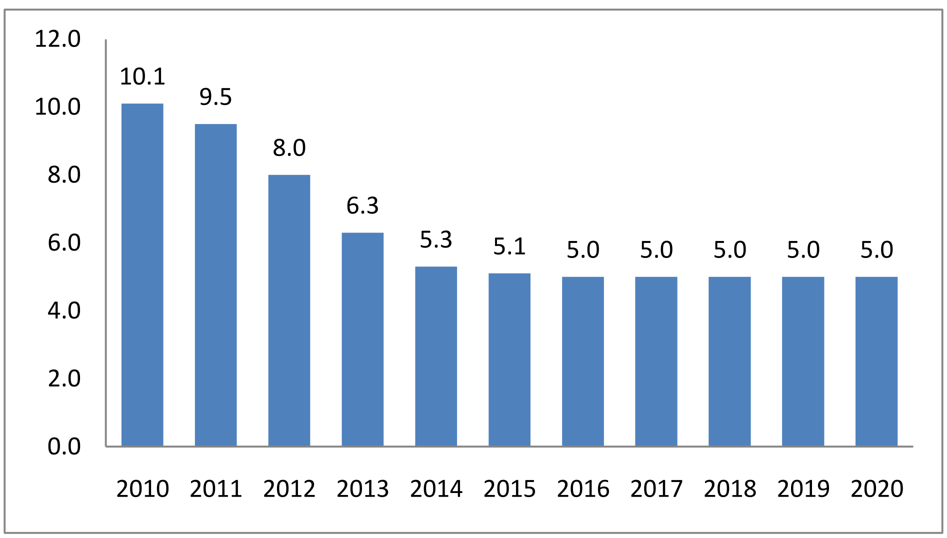
Deficit reduction should take a back seat to job creation.

The economy remains fragile and well below potential. Major deficit reduction should not be on the table until the recovery is firmly on track, that is, until unemployment has dropped significantly and is on a downward trajectory. To be concrete, unemployment should reach 6 percent or lower, and be on a downward trajectory, before any fiscal contraction should be seriously considered. In fact, with unemployment hovering near 10 percent and with projections putting unemployment at elevated levels for at least the next couple of years, further job creation is indeed necessary.

Deficit reduction and job creation are not competing priorities. Job creation is needed today to ensure a strong economy and a solid tax base tomorrow: you can't reach reasonable budget targets without a strong and rapid recovery, and you won't get a strong recovery if you pursue austerity too early.

An array of economic forecasts all show unemployment lingering at historically high levels for an unacceptable duration of time. For example, Goldman Sachs forecasts unemployment to remain in the 9.5 to 10 percent range through the end of 2011. The Congressional Budget Office's (CBO) most recent projections show unemployment averaging 8 percent in 2012 (more than four years after the beginning of the recession) and remaining above 6 percent through 2013 (see Figure A).

Figure A. CBO projected calendar year average unemployment rate



Source: CBO, January 2010

The economic recovery remains fragile and an immediate decrease in federal outlays could jeopardize the budding economic upturn. Falling state and local government expenditure and investment have taken an increasing toll on the recovery over the last three quarters, most recently shaving half a percentage point off of real GDP growth in the first quarter. Consumer spending perked up in the first quarter, but the increase in spending was financed by a depletion of personal savings while real disposable incomes stagnated. With the euro sliding to four-year lows against the dollar, U.S. export competiveness will suffer and a widening trade gap will likely continue to drag at economic growth. A retrenchment of spending in the context of deficit reduction would only serve to further weaken the fragile recovery.

Objective observers agree that the Recovery Act has worked to stimulate growth and create jobs. CBO recently estimated that the Recovery Act added between 1.7 and 4.2 percentage points to real GDP by the end of the first quarter, and increased full-time equivalent employment by between 1.8 and 4.1 million jobs. Without the Recovery Act, the economy would have remained mired in recession or reentered a period of contraction. Other estimates, from Goldman Sachs and Moody's Economy.com among others, have also shown that the Recovery Act has had a significant impact.

As this federal fiscal support fades (and the outlook for state and local budgets continues to deteriorate), the economy will lose some of the support that helped turn the tide. In a worst case scenario, a double-dip recession induced by premature fiscal tightening would counterproductively worsen the medium and long-term fiscal outlook.

(Note that the current budget deficit largely results from short-term economic factors, not from the Recovery Act. In a recent briefing paper, my EPI colleague Josh Bivens notes that the Recovery Act is projected to add only four percentage points to the debt-to-GDP ratio between 2008 and 2019 – a tenth of the total projected increase - suggesting that it is not a significant factor driving the long-term debt trajectory.[1] Further, as the economy recovers, the deficit will drop by about half.)

While the commission does have a 2015 target, any plan must account for the possibility that the recovery may be slower than currently anticipated – and any action that would harm the recovery should be explicitly delayed, perhaps through one or more trigger mechanisms. Further, while it is traditional to phase-in changes over a number of years, any adjustments for 2015 should *not* begin to be phased in immediately, but wait several years until a strong recovery is more certain.

The near-term policy priority must thus be fostering an economic expansion rather than enacting austerity measures to reduce the deficit.

Social Security is not a major driver of long-term deficits

Social Security is currently running a surplus, as incoming payroll tax revenue and interest from the trust fund are more than enough to pay current benefits. Over the longer run, projected Social Security benefit levels are set to exceed dedicated Social Security revenues. However, it is important to keep in mind that Social Security is prohibited from borrowing and therefore cannot add to the deficit once the trust fund is exhausted. In other words, if nothing is done sooner to shore up the system's finances, benefits will simply have to be cut.

[1] See Josh Bivens "Budgeting For Recovery—The Need to Increase the Federal Deficit to Revive a Weak Economy" EPI Briefing Paper #253, January 6, 2010, at http://www.epi.org/publications/entry/bp253/

For Social Security the gap between promised benefits and revenue is only about 0.5-0.7 percent of future GDP.[2] In total, assuming a continuation of current policies, the overall 75-year fiscal gap—the amount of revenue increases and/or spending cuts required to establish debt in the long run at today's levels—is thought to be around 7 to 9 percent of GDP.[3] Thus the Social Security program represents no more than one tenth of the overall fiscal gap—less, if the average is calculated using shares of GDP.

Much, and perhaps all, of the Social Security gap can be closed through changes in the payroll tax that have wide support. Surveys have repeatedly shown that the public supports an increase in the cap on income that is subject to the payroll tax. For example, a poll conducted by the National Academy of Social Insurance for the Rockefeller Foundation found that 83% favor lifting the cap on taxable earnings—the most popular option.[4] An even greater share of America Speaks participants favored lifting the cap, again, by far the most popular option they could choose from.[5]

Not only does polling show that the public is willing to pay more to preserve current benefits, but securing Social Security ranks among the top national priorities. A recent Pew Research Center poll found that securing Social Security ranked as the fourth highest national priority (of 21), trailing behind strengthening the nation's economy, improving the jobs situation, and defending the U.S. against terrorism.[6]

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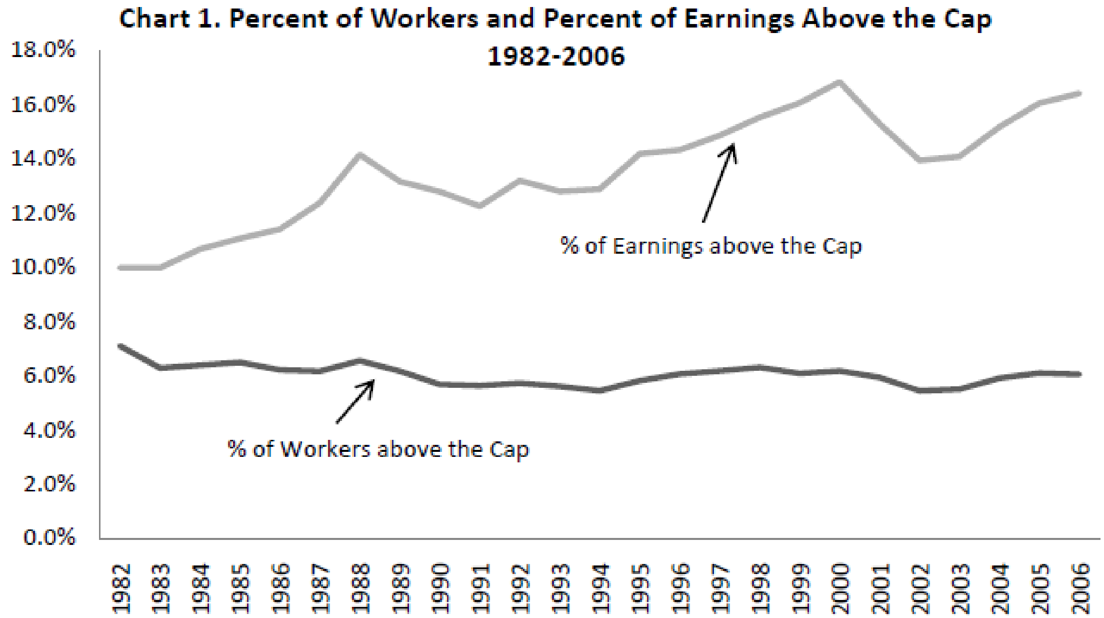
[2] SSA (2009), "Through the end of 2083, the combined funds have a present-value unfunded obligation of $5.3 trillion. This unfunded obligation represents 1.9 percent of future taxable payroll and 0.7 percent of future GDP through the end of the 75-year projection period." CBO (2009), "Under the scheduled benefits scenario, Social Security's 75-year summarized outlays equal 5.7 percent of GDP, and its summarized revenues equal 5.3 percent, CBO projects. The result is a summarized deficit of 0.5 percent of GDP—or 1.3 percent of taxable payroll." http://www.cbo.gov/ftpdocs/104xx/doc10457/08-07-SocialSecurity_Update.pdf

[3] Auerbach and Gale estimate a 75-year gap of 7.2 percent of GDP, while GAO (2010) produces a slightly higher estimate.

[4] NASI poll (funded by the Rockefeller Foundation): 83% favor lifting the cap (most popular option) http://www.rockefellerfoundation.org/uploads/files/d980c5a1-d215-4029-bbe5-9aeaefd12d17.pdf

[5] 85% of America Speaks participants favored raising the cap to cover 90% of earnings—by far the most popular option. Though most benefit cuts were rejected, 52% of America Speaks participants supported increasing the retirement age to 69, an option usually rejected in surveys. However, it's very doubtful whether participants would have supported this option if they had been aware that they could close the entire gap by eliminating the cap altogether (results attached)—this option was not presented to participants. Also, the America Speaks results indicate that participants were averse to raising the payroll tax rate, but previous polls have found that people are willing to pay higher taxes to strengthen Social Security. Preliminary results can be found at http://usabudgetdiscussion.org

[6] See http://people-press.org/report/584/policy-priorities-2010 for details.



Source: Author's calculations based on data from Social Security Administration, Annual Statistical Supplement, 2008.

Over time, the incomes of those at the top have increased more rapidly that middle- and low-income workers, leaving a lower percentage of income subject to the tax (see Chart 1.) An increase in the cap that would cover 90 percent of wages (the level set in 1982 when Congress made significant adjustments in the system) would close between one-third and one-half of the 75-year gap, depending on how the benefit formula were modified. Eliminating the cap altogether would close nearly the entire gap.

One option would be to eliminate the employer-side of the payroll tax while also setting the employee side such that 90 percent of all earnings economy-wide would be covered by the payroll tax.[7] This would reduce the gap by about three-fourths. Another option, which would close the entire gap, would be to subject all earnings to the payroll tax on both the employer and employee side while flattening the benefit formula for earnings above the current cap.

Adjustments to benefit levels must be done in the context of overall retirement security. The recession has hammered private savings, and private pensions have been on a long-term decline. Social Security remains the most important component of retirement income for tens of millions of Americans, and benefit levels should be protected and even expanded in some cases.

[7] See Testimony of John S. Irons, Ph.D. Before the United States Senate Special Committee on Aging Hearing on: "Social Security: Keeping the Promise in the 21st Century" Wednesday June 17, 2009 http://www.aging.senate.gov/events/hr211ji.pdf

Revenue must be a major part of the solution.

The income tax code – both for individuals and corporations—is broken and needs to be fixed. We must look to create a tax code that raises adequate revenue in a way that is fair and that does not overly burden families and businesses.

It is important to note that the long-term imbalance is driven by inadequate revenue, not just cost increases. In 2010, as a result of the recession which has led to less taxable income, revenues are expected to be at or near historically low levels at about 15 percent of GDP. Over the next 10 years, under the President's budget scenario, revenues would recover to average about 19 percent of GDP – about five percentage points less than spending over that time. Under a "current policy" scenario which includes a full extension of the 2001-2003 tax changes, revenue would be even less.

More generally, the federal government is not raising sufficient revenue to cover expenses. Mechanically, greater revenue can be raised by increasing the amount of taxable income or transactions and/or by increasing tax rates. Increasing taxable income can be accomplished by 1) increasing individuals' incomes (e.g. through a more rapidly growing economy) 2) broadening the base to include more sources of income or additional transactions, or 3) by reducing deductions that reduce taxable incomes.

The cost of the 2001 and 2003 tax changes (and a fix to the AMT) represent about 40% of the "current policy" deficit in 2015 and are responsible for a revenue loss of about 2.3 percent of GDP. These tax changes provided large tax reductions for high-income individuals – precisely that group that has seen the greatest increase in both pre- and post- tax incomes over the last 3 decades. Between 1979 and 2007, average pre-tax income for the top 1% of households (those making more than $350,000) has increased by 241%, while their post-tax income has increased by 281%. By contrast, middle income households have seen just a 19% increase in pretax incomes, and a 23% increase in post-tax incomes. Allowing tax cuts for upper-income taxpayers to expire would go a long way towards achieving long-run sustainability without placing an undue burden on those hit hardest by the recession.

Aside from changes in the rate structure, there are also other areas that need to be addressed, including permanent fixes to the estate tax, the AMT, R&E tax credits, etc. Additional information can be found in my prior testimony to the President's Economic Recovery Advisory Board.[8]

In addition to fixing the code, we should also look to other areas to raise revenue while promoting other goals. Specifically, we should look to measures designed to reduce emissions of greenhouse gases, including a carbon tax or auctioned carbon permits. A financial transactions tax or bank tax could also yield significant revenue and be an important part of financial regulatory reform (perhaps instituted on a global basis as was discussed at the recent G20 meetings.)

Increased revenues will impact the long-run deficit in two ways. First and most obviously, additional annual revenue would close the fiscal gap on an annual basis. Second, the additional revenue would

[8] See http://johnirons.posterous.com/presentation-to-presidents-economic-recovery

allow the federal government to borrow less, and help avoid ballooning interest expenses that compound over time.

It is important to note that even with level spending the budget can still explode if revenue is inadequate – deficits will lead to higher interest costs, which could spiral upward. These interest costs are a major source of long-term increase in the deficit and debt levels. As a matter of pure math, debt costs can be brought down through higher levels of revenues or through lower spending; the interest cost problem is thus as much about revenue as about spending.

Health Care reform essential – reduction in growth rate of health care costs is key.

Increased costs for health care are the prime driver of long-term deficits. Since the federal government funds much of health care spending through Medicare and Medicaid, federal spending on these programs are set to rise faster than the economy as a whole. Without Medicare and Medicaid, the federal budget (excluding interest) is near balance in 2050 and beyond.[9]

It is important to note that Medicare costs have risen more slowly than private sector insurance; since 1970, private insurance costs have risen 48% faster than Medicare payments.[10] Fundamental health reform that reduces the growth in the cost of health care is key to long-run budget sustainability.

Recently enacted health care reform will begin the process of reducing costs – with savings that increase over time. Importantly, the health care reform will create an infrastructure for determining what kinds of cost containment mechanisms are effective. Over time, effective measures should be expanded, creating more savings than what is currently projected.

Public investment is essential.

Recessions have long-term consequences,[11] thus even "short-term" recovery spending can have enormous long-term benefits. Public investment will boost growth in the short-run, and lead to greater economic capacity down the road.

Traditional economic analysis suggests that a well-designed stimulus can have more than a 1-1 impact on GDP, and also that some of the costs will be recouped initially through higher tax receipts. In the future, since GDP levels and growth rates are persistent over time, this will mean lower deficits in future years. (Debt levels might be higher or lower depending on how long-lasting is the impulse to GDP.) Thus deficit reduction in 2015 can be assisted by public investments today. See Appendix A below.

Over the long term, we must ensure that the US economy rests on a solid foundation. The foundation must support strong overall growth and rapidly rising in incomes for all Americans – not just those at the top. Public investments in infrastructure (including transportation, information, and water systems),

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[9] See Josh Bivens "Budgeting For Recovery—The Need to Increase the Federal Deficit to Revive a Weak Economy" EPI Briefing Paper #253, January 6, 2010, at http://www.epi.org/publications/entry/bp253/

[10] Ibid.

[11] See John Irons, "Economic scarring: The long-term impacts of the recession" Economic Policy Institute, Briefing Paper #243, September 2009, at http://www.epi.org/publications/entry/bp243/.

investments in education from early childhood through higher education, investments in innovation, investments in health systems, and many other areas are key to providing this foundation. These investments cannot be sacrificed in the name of deficit reduction, for this would put the US economy in a weaker position to address the long-term imbalances that will grow in the coming decades.

Deficit reduction cannot be done in a vacuum. We must consider key questions: What kind of country do we want to rebuild? What is the best way to preserve retirement security? How many resources should we as a nation devote to education, to scientific and human research, or to national defense? Deficit reduction without this context is purely an arithmetic exercise, and the result will lack credibility and will likely result in a failure to make progress on this important issue.

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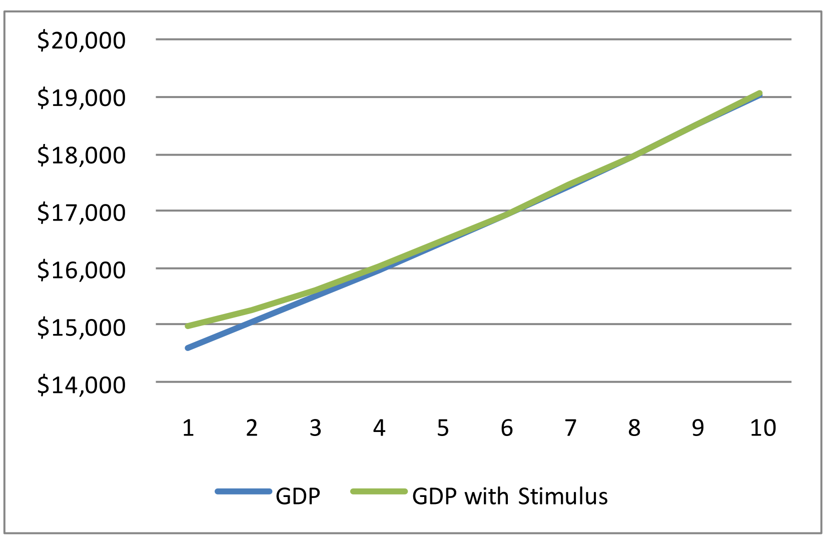
Appendix A. Example: Impact of stimulus on revenues.

Suppose congress enacts a stimulus equal to 2 percent of the economy in a given year and that the boost to GDP in that year is slightly greater than 1-1 – we assume 1.25. Figure E1 shows the path of GDP both with and without the stimulus, assuming that the boost in GDP is temporary, but that it persists for several years.[12]

Figure E 1. Illustrative GDP with and without additional stimulus



[12] Underlying GDP potential is assumed to grow at 3% per year. With stimulus, GDP is assumed to grow by 3% with a downward adjustment equal to $\beta*(yp-y)\_t-1$ with *yp* the potential GDP and *y* equal to actual GDP. The constant β determines the persistence of GDP relative to potential and is here set to 0.45 for illustrative purposes.

The increase in GDP will result in additional tax collections as well as automatically lower spending on social safety net programs. We assume, similar to the results of the CBO model, that a dollar boost to GDP would yield a $0.35 reduction in the deficit. Figure E2 shows the impact on the deficit of the stimulus over 10 years. In the first year, the stimulus will lead to an increase in the deficit equal to about 56% of the initial cost of the stimulus – because the boost to the economy is greater than 1-1 and because some of the cost is recouped through higher GDP. In subsequent years, because GDP remains above pre-stimulus levels for several years, *the deficit is lower than it would have been otherwise.* In this example, the deficit is lower by about 0.5% of GDP in the first year after enactment, and 0.3% of GDP lower in the second year. In total, the net multi-year cost is approximately zero; however, the multi-year cost could be either less (or greater) than zero if GDP is more (or less) persistent.

Figure E 2. Illustrative impact on deficit of additional stimulus.